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FINANCIAL STATEMENTS MANIPULATION TECHNIQUES

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ABSTRACT

Financial statements are basic source of accounting information used for decision making. All users presume that financial statements are reliable and offer realistic picture of the company's financial position. If some part or entire financial statement is manipulated decision making process of users is corrupted. The history shows that some large financial statements manipulations or frauds were eventually exposed and this diminish reliability of financial statements in general. This paper aims to give an overview of most common manipulation techniques. The purpose of this paper is to help users of financial statements understand manipulation techniques in order to improve their decision making process.

KEYWORDS: manipulation, financial statements, manipulation techniques.

INTRODUCTION:

Financial statements are basic source of accounting information used for decision making. Spectre of users is wide and goes from external users such are for example investors and creditors to internal users such are owners, executives and employees. All users assume that financial statements are reliable and prepared in accordance with all other basic accounting principles.

Croatia adopted International financial reporting standards (IFRS) and also issued Croatian financial reporting standards (HSFI). According to the Accounting act large companies and companies that are listed on stock market are obliged to apply IFRS. On the other hand medium size and small companies apply Croatian financial reporting standards. Croatian financial reporting standards in some areas differ from IFRS and, for example, simplify regulation for small and medium size companies, but general principles are adopted from IFRS.

Financial reporting standards set basic accounting principles and among other include:

- *Accrual principle:* the transactions should be recorded in the reporting periods when it actually occurs, rather than in the periods when it brings cash inflow or outflow
- *Conservatism principle:* the company should recognize expenses and liabilities as soon as possible, but recognize revenues and assets only when it is sure that they will occur
- *Consistency principle:* used accounting principle or method should be consistent trough time. If it changes the company is obliged to present the effects of the change
- *Cost principle:* a company should record its assets, liabilities and equity at their original purchase costs in the year of purchase.
- *Economic entity principle:* the transactions of a company should be presented
- *Going concern principle:* it is presumed that the company will remain in operation for the foreseeable future
- *Matching principle:* when revenue is recorded all related expenses should be recorded at the same time.
- *Materiality principle:* material transaction is the one which if it is not recorded might have altered the decision-making process of the financial statements user
- *Reliability principle:* financial statements should include only those transactions that can be proven
- *Revenue recognition principle:* revenues should be recognized only when the company has substantially completed the earnings process.
- *Time period principle:* financial statements should include comparable reporting over a period of time

Literature offers several different definitions of manipulations, but for the purpose of this paper any deviation from regulations set by financial reporting standards will be considered as manipulation.

The aim of this paper is to give overview of most often used manipulation tecqniques and search for motives to implement them.

The paper is structured as follows. After the introduction, review of the literature dealing with this issue follows. Description of manipulation techniques is given in section three and the paper concludes with concluding remarks.

LITERATURE OVERVIEW:

According to Amat, Blake and Dowds (1999) creative accounting is a process where accountants use their knowledge of accounting legislation with the purpose of manipulating numbers which represent company’s performance.

Although originated in the accounting, most authors agree that initiative for manipulation generally comes from management, while accounting ledgers and accountants are just instrument that management use to accomplish their goals.

Mulford and Comiskey (2002) believe that major motives for manipulation are stock price, reducing costs of debt, bonuses and award to the management and tax elusion

In his research Gulin (2009) states that manipulation with stock market prices of shares is the source of manipulations in financial statements and that they increase conflict between different interest groups, for example conflicts between corporations and tax authorities, and especially conflict of interests between investors, management and employees.

Aljinović Barać and Klepo (2006) in their research state that problems of accounts manipulations in Croatia are significant, especially in the way of getting certain fiscal benefits, better terms of indebtedness and hiding bad performance. The research also point¬ed out that accounts manipulations are very common praxis in area of depreciation policy, write-off of accounts receivable, taxes, inventories, revenues, provisions and contingencies, revalorization, asset impairments and long-term investments in finan¬cial instruments.

Balaciu Diana Pop Cosmina Madalina (xxx) in their paper state that accounting manipulation is defined as when the managers of an organization intentionally misstate their financial information to favourably represent the entity’s financial performance. They also argue that accounts manipulation represents the use of management’s discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and society (political costs), funds providers (cost of capital) or managers (compensation plans). They conclude that the accounts manipulation has a direct influence in modification of the apparent performance (as measured, for example, by the earnings per share) and/or a modification of the company’s financial structure. The conflicts of interest among different interest groups represent the real causes of creative accounting:

the managers are interested in paying less taxes and dividends, the shareholders in gain higher dividends, the employees to obtain better salary and higher profit share, the authorities to collect more taxes. It can be easily seen that the interests are tremendous divergent and creative accounting is deepening it.

Dimitrijević (2015) states that the tendency of managers to embellish the results

of the business and the financial position of the company and to show its performances better than they really are lead to the financial statement manipulation, which can be marked as one of the main means of committing frauds. A company's management is under constant pressure to achieve as good results as possible, especially in the conditions of a financial crisis. This pressure forces the management to resort to many forms of financial manipulation more frequently in order to show the expected business results. In addition to this pressure, many managers resort to financial frauds so as to achieve personal goals, get extra bonuses or avoid being fired.

Most common manipulation techniques:
Profit and loss account shows revenues, expenses and profit or loss for a certain time period (a year, quarter etc.).

Profit and loss account provides information for analysis of companies performance and besides final net profit or loss, even more important figures are sales revenues, operating profit or loss profit and loss (EBITDA, EBIT).

Considering the importance of al levels of Profit and loss account it is of great importance that all position are classified correctly and give fair and realistic picture of companies performance.

Practical experience shows that very common case of malpresentation is stating extraordinary items as ordinary. Extraordinary transactions are those that are not related to the core business operations and that don't occur repeatedly. Presenting extraordinary revenues as regular operating revenues would directly positively influence operating results, such as EBITDA or EBIT. As of reporting year 2016 extraordinary items are not separately presented so the issue of their presentation is resolved.

Recording revenue prematurely or recording non-existing (fictious) revenues:
Recorded revenues are key element for evaluating company's performance. They directly influence all presented results which means that misrepresentation of revenues directly leads to misrepresentation of results, thus giving investor or other shareholders wrong picture of company's performance. This is the major motive for manipulating revenue presentation. Recording revenue prematurely or recording fictious revenue effects presented financial statements, however that effect increases when such financial statements are basis for projections and planning. Projections include revenue growth or decline by some percentage which multiplies the effect of wrongly presented revenue. Newly founded companies are especially sensitive to such manipulations because their revenues are in the first year low, but are expected to multiply in the coming years which multiplies effect of manipulation considerably. Same applies for companies with very fast revenue growth, such were at their beginning for example internet "dot.com" companies.

Recording revenue prematurely or recording fictious revenue differ in the gravity of manipulation.

Prematurely recorded revenue is an actual revenue based on business transaction, but which is recorded prior to fulfilling all principles necessary to recognize revenues according to the financial reporting standards. According to the financial reporting standards revenues can be recognized when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.

Recording revenue prematurely is often done to cover actual decline in revenues, sales or operations in general. Motives for such manipulation are different. Management or owners can use this to cover negative trend which they expect is temporary and will be compensated in the next period. Employees or all level managers can find motives for this manipulation in bonuses, carrier advances etc. In any case, although such revenue recording is manipulation, it is most often not a sign of complete company failure but more often individual interests or profit.

Recording fictious revenue means that recorded revenue is not based on an actual business transaction, that it never really occurred. If we wanted to grade gravity of those two manipulations it is obvious that recording questionable or nonexisting revenues is far worse than recording actual revenue in "wrong" period. Inventing and recording non-existing revenue is a manipulation most often done by the owners or highest level of management and the motive is usually to hide actual serious troubles of the company.

Aggressive cost capitalization and prolonged amortizing period:
Incorrect presentation of current costs as assets (capitalization of costs) in the financial statements significantly increases presented results. Such assets will be depreciated and will charge costs in the several following periods, while entire cost amount in fact should be charged in the current period. This manipulation will distort entire picture of the company's financial standing and if materially significant may lead to wrong conclusions and influence decisions.

According to the financial reporting standards during usage period of the assets some costs may arise. If those costs prolong usage period of the asset or they increase usage value, such costs can be capitalized and treated as assets. However, if costs are used to keep existing function such costs should be recognized as expenses in the period they occurred.

According to the International financial reporting standards assets can only be recognized when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. Otherwise, such costs should be recognized as expenses.

This is often the case in software development companies because it is difficult to distinguish development costs which should be recognized as expenses and the moment they become an asset. Financial reporting standards define that internally developed intangible assets (software) can be recognized as assets if and only if they can prove technological feasibility, probable future benefits, intent and ability to use or sell the software, resources to complete the software and ability to measure cost. Otherwise, development costs should be recognized as an expense.

Owners or management can easily use this to manipulate results. They can simply not make feasibility study and therefore costs would be correctly classified as expenses thus decreasing results. Motive for this manipulation can be tax evasion or creating space for next year increase of profitability if that is determinant for bonuses etc.

On the other hand they can capitalize costs for software development despite the regulation and this was increase company's results.

Capitalization of borrowing costs:
Depending on the proportion of debt used to finance activities company is faced with slower or higher borrowing costs. Borrowing costs may include interest expense, finance charge and exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Financial reporting standards define that borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' (one that necessarily takes a substantial period of time to get ready for its intended use or sale) are included in the cost of the asset. Other borrowing costs are recognized as an expense.

As other previously described this manipulation also directly influence Income statement and presented results.

Prolonged depreciation:
According to the financial reporting standards the depreciable amount (cost less residual value) should be allocated on a systematic basis over the asset's useful life. The residual value and the useful life of an asset should be reviewed at least at each financial year-end and.

The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity and a depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The depreciation method should be reviewed at least annually. Depreciation should be charged to profit or loss, unless it is included in the carrying amount of another asset.

Depreciation begins when the asset is available for use and continues until the asset is derecognized, even if it is idle.

Existence of prolonged depreciation period can be detected by:

- Calculating average useful life of all depreciable assets and comparing it with peers or benchmark of the industry
- Searching for existence of prolonged depreciation period in previous years

Balance sheet manipulation techniques:
Misrepresentation within balance sheet can lead to distorted picture of liquidity, financial stability, indebtedness etc. one should bear in mind that Profit and loss account and Balance sheet are in fact related and that some transaction affect both statements.

Accounts receivables:
The most common case of accidental or deliberate malpresentation of assets is trough accounts receivable. This position can contain receivables based on prematurely recognized or fictious revenue. More often, this position is unrealistic because of collectability of the accounts receivable. Non-collectable receivables should be value adjusted, meaning they should be recognized as expenses within Profit and loss account. If accounts receivable increase more rapidly than revenues calculated average collection period is prolonged. This should be compared with previous periods, with company's peers or industry benchmarks which may indicate that there are some old or non collectable receivables within this positions.

If company is recording fictious revenue, receivables are in fact entirely non col-

lectable so they would continuously rise from period to period.

Inventories:
Inventories can be viewed as costs of goods sold temporarily kept in the Balance sheet. When inventories are sold cost of goods sold is recorded in the Profit and loss account. In case that inventories are overestimated costs would be underestimated thus directly influence the profit to also be overestimated. Also, considering that inventories are liquid assets, this would also positively influence liquidity and all other ratios calculated from the balance sheet, thus leading the shareholder to wrong conclusion.

Inventories can be overestimated in the way to record larger quantities that actual ones. This can be done by recording fictious inventories trough inventory lists or not to write off destroyed and malfunction inventories.

Inventories can be overestimated simply by increasing their financial value without backing it up with physical existence of the inventories.

However, the most common way to manipulate inventories is not to make adequate value adjustments of non-current inventories.

Accruals:
Accruals are receivables or liabilities for transactions in which revenues or expenses don't comply with conditions for their recognition in the current period, but recognition is expected in a future reporting period. Accruals are also revenues or expenses which occurred in the current period but receivables or liabilities can't be recognized in the current reporting period. In case of manipulation with accruals the company can present unrealistic revenues or expenses thus influencing final result, but also can present unrealistic receivables or liabilities thus influencing conclusion drawn from analysis of the balance sheet.

Accounts payable (suppliers):
Underestimated accounts payable are mostly directly related to underestimated assets or inventories. Detection of such manipulation is possible trough analysis of accounts payable turnover days.

CONCLUSION:
Financial statement manipulation or creative accounting can influence decisions making on all levels. Accounting manipulation can include one person or large number of people from owners, executives, managers, employees, external consultants and others. As number of participants can vary, so can their motives, even though bottom line of all motives is usually personal gain of some sort. Motives for manipulations vary from wanting to present better results to gain bonuses, covering poor results of the company, but also motives can be quiet opposite by presenting lower results for the purpose of tax evasion. There is a large number of techniques for manipulating financial statements. Malpresentations can be stated in Profit and loss account or in the balance sheet, and they would than reflect to all other company's reports. Accounting regulation aims to diminish possibilities for manipulation and auditing financial statements is certainly the most effective way to do so, however one must keep in mind that manipulations are fraud and as such they will always exist. It is important for investors or stakeholders to understand presented basic manipulation techniques in their decision making process based on financial statements.

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